

Market Update



Evergreen Investments™

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June 2, 2009 | An Investment Strategy Newsletter

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Market Performance

The powerful equity market rally continued in May, with the S&P 500 Index climbing by more than +5.0% last month. Since the market has rallied off its March 9th lows, the S&P 500 has enjoyed its best three-month gain (+25%) since 1938! Gains were broad-based in May, with all the major market indicators rising, especially in the international arena with impressive gains for both emerging and developed markets. The yield on the benchmark 10-year Treasury surged as investor fears escalated regarding the potential consequences of current fiscal spending and monetary policy. Considering this, the rest of the bond market held up relatively well during May. Commodities were led by solid gains in the prices for both oil and gold while the dollar weakened. See Chart 1 for more details of Market Performance.

The equity market, as defined by the S&P 500 Index, remains above our projected “sustainable” trading range (650ish-850ish) originally highlighted in our March 3rd, 2009 issue of Market Update. The market’s technicals, or chart-based patterns, continue to improve with S&P 500 having just recently managed to move through, and hold above, its 200-day moving average for the first time in more than one year. Given large cash positions on the sidelines, this development may result in further gains toward the 1000 level in the coming weeks.

While we are pleased with these technical gains, we remain most concerned about the market’s ability to sustain profit growth on economic data that is simply “less bad” over the next few quarters. Assuming the S&P 500 reaches our projection for \$50.00 in operating earnings in 2009, we are rapidly approaching a P/E of 20 times this year’s profits, a level we would consider pricey given the still unresolved issues of credit availability, rising unemployment, declining home values, auto bankruptcies, and the possibility for more bank re-capitalizations. We recognize that a lot of money has been created to fight this crisis and it needs to find a home, but we would prefer that the market have a more solid profit foundation upon which to base its footing. As a result, we would view any rapid gains from current levels over the next few months with suspicion.

U.S. Economy

The contraction in first quarter gross domestic product (GDP) was revised to a narrower rate of -5.7% from the original estimate of -6.1%. The revision was largely attributed to a milder drop in business inventories and improved trade data. However, personal consumption and government expenditures were revised lower for the quarter, which despite the improvement from the first estimate, still represented the second worst period for economic output in more than 25 years.

We continue to believe the worst of the economic pain is behind us. After the fall of Lehman last September, intra-bank lending rates skyrocketed, resulting in a complete seizure in the credit markets. The

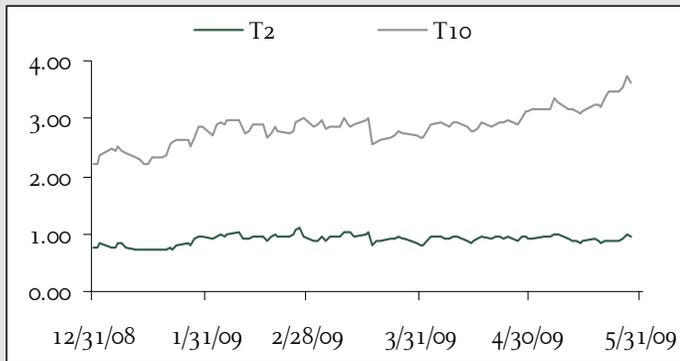
1. Market Performance as of 5/29/09

EQUITIES	5/29/09 LEVEL	May TOTAL RETURN	YTD TOTAL RETURN
Dow Jones Industrials	8,500.33	4.5	-1.6
S&P 500	919.14	5.6	3.0
NASDAQ	1,774.33	3.3	12.5
Russell 2000	501.58	3.0	1.1
S&P MidCap	575.52	2.7	7.8
Russell 1000 Growth	406.15	5.0	10.3
Russell 1000 Value	469.61	6.2	-2.1
MSCI EAFE	1,317.31	11.8	8.6
MSCI (Emerging Markets)	773.12	17.1	37.9
FIXED INCOME	5/29/09 LEVEL	May TOTAL RETURN	YTD TOTAL RETURN
10-Year Treasury	3.47	-2.7	-8.6
Barclays Aggregate	4.11	0.7	1.3
Barclays Municipal	3.91	1.1	7.4
Barclays Corporate	6.33	3.9	5.4
Barclays High Yield	13.73	6.7	26.8
Barclays Mortgage	4.16	0.3	2.8
Barclays Global ex. US	2.44	4.5	-0.8
COMMODITIES & CURRENCIES	5/29/09 LEVEL	May TOTAL RETURN	YTD TOTAL RETURN
CRB Index	253.05	13.8	10.2
Crude Oil - WTI	66.31	29.7	48.7
Gold	980.30	10.0	10.9
Trade Weighted Dollar	79.43	-6.3	-3.3

Source: Factset, Bloomberg, Barclays, Evergreen Investments.
*Total Return includes price appreciation & dividend income for equities.
Past performance is not indicative of future results. It is not possible to invest directly in an index.

massive policy response from officials at Treasury and the Federal Reserve has led to a dramatically improved credit environment, yet not a completely healthy one. Consequently, we suspect data over the next several months may be simply “less bad,” but not great, as the lagged effects of government stimulus begin to gradually take hold. Given recent data on durable goods, manufacturing and retail sales, we expect GDP to contract by approximately -2.0% in the current quarter.

2. 10-Year Treasury vs. 2-Year Treasury



Source: Baseline and Evergreen Investments

Fed and Rates

Have the bond market vigilantes returned? These global investors who frequently put the screws to the Fed and Treasury when inflation and spending fears surfaced during the 1970's, 1980's and 1990's have largely been absent during this young century. As the massive federal policy response to the financial crisis has escalated, though, the market's fears have risen regarding dollar weakness and potential pricing pressures. Consequently, these bond vigilantes have once again taken justice into their own hands, dumping their Treasury holdings and pushing yields higher over the past several weeks. Indeed, the resulting sell-off has pushed the interest rate differential, or spread, between 2-year Treasuries and 10-year Treasuries among its widest in history. See Chart 2. In addition to the inflation fears, the markets have also become wary of the amount of issuance required to further sustain deficit spending. Given the federal deficit of approximately \$450 billion in fiscal 2008 and tracking toward \$2 trillion in fiscal 2009 (ending in September) the market seems to be asking a simple question: How can you quadruple the supply of something without forcing its price down?

Fortunately or unfortunately, the answer seems to be the opposite of what logic would suggest, at least over the next couple of quarters. To be sure, it is critical to keep in mind that while the market has been dumping Treasuries, the Fed has largely kept on the sidelines. We remind investors that in late March, monetary policy makers pledged to purchase up to \$300 billion in longer-dated Treasury securities in an attempt to augment their commitment to buy \$1.25 trillion in mortgage-related investments. The Fed has thus far made good on about one-third of its mortgage pledge and up to one-half of its Treasury commitment. Considering the fragile state of the economy, we doubt the Fed is willing to abandon its efforts to support the housing recovery by keeping mortgage rates low. Moreover, minutes from the most recent policy meeting indicate the central bank is willing to consider further purchases of Treasuries in their endeavor to keep interest rates low “for an extended period.”

Indeed, we believe it is these four words - for an extended period - that may prove to be among the most powerful weapons in this crisis. From our perspective, monetary policy tends to be binary in that the Fed doesn't mind surprising financial markets with a cut in interest rates, since the reaction in equities and fixed income tends to be positive. Yet we believe policy makers are loathe to surprise investors with a tightening of credit, particularly with the still weak economy and a spirited debate raging as to whether or not certain financial institutions are “too big to fail.” As such, we believe the Fed is not done with Treasury purchases and it is entirely possible that the aforementioned \$300 billion Treasury purchase program could be extended over the next couple of quarters. The bond vigilantes have been heard and we suspect they have nothing to worry about, at least until those four precious words are someday removed from the Fed's policy statement.



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John is a Managing Director and Chief Market Analyst for Evergreen Investments. A member of the firm's Investment Strategy Committee, John uses a top-down, macro-economic approach in his analysis of the financial markets. He has been featured in various media outlets, including CNBC, BusinessWeek, CNN-Money, Bloomberg News and The Wall Street Journal.

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